

**A critical commentary on and analysis of the general anti-avoidance section in the
Income Tax Act 58 of 1962 paying particular attention to the introduction of the
so-called business purpose test.**

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Income Tax Act 58 of 1962 paying particular attention to the introduction of the
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Being a technical report submitted by

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to

the University of Natal

in part satisfaction of the requirements of the award of the degree of

Masters of Commerce

ABSTRACT

The aim of this technical report is to provide a detailed and critical commentary on and analysis of the general anti-avoidance section in the Income Tax Act 58 of 1962 paying particular attention to the introduction of the so-called business purpose test.

The South African Acts that are the subject of this technical report are as follows:

- The Income Tax Act 58 of 1962.
- The Income Tax Act 21 of 1995.
- The Income Tax Act 36 of 1996.
- The Revenue Laws Amendment Act 46 of 1996.
- The General Law Amendment Act 49 of 1996.
- The Income Tax Act 28 of 1997.
- The South African Revenue Service Act 34 of 1997.
- The Estate Duty Act 45 of 1955.
- The Value-Added Tax Act 89 of 1991.
- The Transfer Duty Act 40 of 1949.

The principal South African taxes dealt with in this technical report are as follows:

- Normal Tax.
- Donations Tax.
- Estate Duty.

Also covered is the legislation contained in the abovementioned Acts affecting estate planning schemes, generation skipping devices, income splitting schemes and tax avoidance schemes.

DECLARATION

I hereby declare that this report is entirely my own work.

ACKNOWLEDGEMENT

I would like to express my thanks to Professor Lindsay Mitchell, my supervisor, for his assistance and advice in the compilation and preparation for submission of this material, to Susan Trollip for her invaluable assistance in processing my data and rendering it suitable for submission in the required form.

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Introduction

By comparison with other countries, South Africa has high marginal tax rates, and its taxpayers, to minimise their liabilities, sometimes resort to aggressive tax planning. The South African system of taxation under the Income Tax Act (the Act) entails working out a taxpayer's gross income (receipts and accruals), subtracting from it any income exempt from tax, subtracting from the resultant income any allowable deductions, and thus arriving at taxable income.

It is on this last amount that tax is levied (*CIR v Nemojim (Pty) Ltd*),¹ at progressive rates of tax in the case of non-corporate taxpayers, so that the greater a non-corporate taxpayer's taxable income, the greater the percentage of tax due by the non-corporate taxpayer.

The South African courts have recognised the principle from *IRC v Duke of Westminster*² in that every man is entitled to arrange his affairs in such a manner that the tax attaching under a particular tax statute is less than it would otherwise have been (*Hicklin v SIR*³).

To gain the tax benefit under any arrangement of his financial affairs, though, the taxpayer must use legitimate methods that do not infringe section 103. In other words, a taxpayer has a right, subject to statutory limitations, to structure his financial affairs so as to remain outside the provisions of a particular tax statute. There is a clear distinction between tax evasion and tax avoidance. Tax avoidance is an attempt to minimise a tax liability using legal means, that is, to regulate a taxpayer's affairs so as to pay the minimum amount of tax.

¹ 83 AD 301, 45 SATC 291.

² 19 TC 490.

³ 80 AD 481, 41 SATC 179.

Tax evasion, on the other hand, involves the use of illegal means to reduce tax liability, for example, falsification of books, suppression of income and fraudulent non-disclosure of income.

It is important to distinguish between these two concepts because while *avoidance* is perfectly legal, *evasion* is illegal and could result in severe penalties, for example, fines and imprisonment. Because tax evasion constitutes a criminal offence, the fiscus does not require a statutory law to cope with this type of misdemeanour. Tax avoidance, on the other hand, does not fall foul of the Act *per se* and any protection, which the Commissioner for the South African Revenue Service requires, must be incorporated in the statute.

Ever since the decision in the *Duke of Westminster* case, there has been a change in mindset amongst taxpayers as they have realised that it is a taxpayer's constitutional right to arrange his affairs in the most optimal manner so that he will eventually pay the least amount of tax, provided he remains within the clear boundaries of the law and does not intentionally or unintentionally end up in the realm of tax evasion.

It has been repeatedly stated that no person is obliged, legally or morally, so to arrange his affairs as to pay the largest possible amount of tax. In *Partington v Attorney General*⁴ Lord Cairns stated the following:

'As I understand the principle of all fiscal legislation, it is this: If the person sought to be taxed comes within the letter of the law, he must be taxed, however great the hardship may appear to the judicial mind to be. On the other hand, if the Crown, seeking to recover the tax, cannot bring the subject within the letter of the law, the subject is free, however apparently within the law the case might otherwise appear to be. In other words, if there be an equitable construction, certainly such a construction is not admissible in a taxing statute, where you can simply adhere to the words of the statute.'

⁴ LR 4 HL 100 at 122.

In *Cape Brandy Syndicate v IR*⁵ Rowlatt J stated the following:

'In a taxing Act one has to look merely at what is clearly said. There is no room for any intendment. There is no equity about a tax. There is no presumption as to a tax. Nothing is to be read in, nothing is to be implied. One can only look fairly at the language used.'

In the *Duke of Westminster* case Lord Tomlin stated the following:

'it is said that in revenue cases there is a doctrine that the court may ignore the legal position and regard what is called "the substance of the matter", and that here the substance of the matter is that the annuitant was serving the Duke for something equal to his former salary or wages, and that therefore, while he is so serving, the annuity must be treated as salary or wages. This supposed doctrine (upon which the Commissioners apparently acted) seems to rest for its support upon a misunderstanding of language used in some earlier cases. The sooner this misunderstanding is dispelled, and the supposed doctrine given its quietus, the better it will be for all concerned, for the doctrine seems to involve substituting "the incertain and crooked cord of discretion" for "the golden and streight metwand of the law". Every man is entitled if he can to order his affairs so as that the tax attaching under the appropriate Acts is less than it otherwise would be. If he succeeds in ordering them so as to secure this result, then, however unappreciative the Commissioner of Inland Revenue or his fellow taxpayers may be of his ingenuity, he cannot be compelled to pay an increased tax. This so-called doctrine of "the substance" seems to me to be nothing more than an attempt to make a man pay notwithstanding that he has so ordered his affairs that the amount of tax sought from him is not legally claimable.'

In the same case, Lord Russell said the following:

'I confess that I view with disfavour the doctrine that in taxation cases the subject is to be taxed if, in accordance with a Court's view of what it considers the substance of the transaction, the Court thinks that the case falls within the contemplation or spirit of the statute. The subject is not taxable by inference or by analogy, but only by the plain words of a statute applicable to the facts and circumstances of his case.'

⁵ (1921) 1 KB 64 at 71.

He went on to say the following:

'... If all that is meant by the doctrine is that having once ascertained the legal rights of the parties you may disregard mere nomenclature and decide the question of taxability or non-taxability in accordance with the legal rights, well and good. ... If, on the other hand, the doctrine means that you may brush aside deeds, disregard the legal rights and liabilities of the parties being different from what in law they are, then I entirely dissent from such a doctrine.'

It seems that taxpayers are free, if they can, to make their own arrangements so that their financial affairs may fall outside the scope of taxing Acts. They incur no legal penalties and, strictly speaking, no moral censure if, having considered the lines drawn by the legislature for the imposition of taxes, they make it their business to walk outside them.

This was emphasised in *Vestey's (Lord) Executors v IRC*⁶ when Lord Normand stated the following:

'Parliament in its attempts to keep pace with the ingenuity devoted to tax avoidance may fall short of its purpose. That is a misfortune for the taxpayers who do not try to avoid their share of the burden, and it is disappointing to the Inland Revenue. But the Court will not stretch the terms of taxing Acts in order to improve on the efforts of Parliament and to stop gaps which are left open by the statutes. Tax avoidance is an evil, but it would be the beginning of much greater evils if the Courts were to overstretch the language of the statute in order to subject to taxation people of whom they disapproved.'

In contrast, the following was stated by Lord Scarman in *Furniss v Dawson*:⁷

'My Lords, I would allow the appeals for the reasons given by my noble and learned friend Lord Brightman. I add a few observations only because I am aware, and the legal profession (and others) must understand, that the law in this area is in an early stage of development.'

⁶ (1949) 1 A11 ER 1108 (HL) at 1120.

⁷ [1984] 1 AER 530 at 532.

He went on to say the following:

'Speeches in your Lordships' House and judgments in the appellate courts of the United Kingdom are concerned more to chart a way forward between principles accepted and not to be rejected than to attempt anything so ambitious as to determine finally the limit beyond which the safe channel of acceptable tax avoidance shelves into the dangerous shallows of unacceptable tax evasion. The law will develop from case to case. Lord Wilberforce in *W T Ramsay Ltd v IRC* [1981] 1 A11 ER 865 at 872, [1982] AC 300 at 324 referred to the "emerging principle" of the law. What has been established with certainty by the House in Ramsay's case is that the determination of what does, and what does not, constitute unacceptable tax evasion is a subject suited to development by judicial process. The best chart that we have for the way forward appears to me, with great respect to all engaged on the map-making process, to be the words of Lord Diplock in *IRC v Burnah Oil Co Ltd* [1982] STC 30 at 32 which my noble and learned friend Lord Brightman quotes in his speech. These words leave space in the law for the principle enunciated by Lord Tomlin in *IRC v Duke of Westminster* [1936] AC 1 at 19, [1935] A11 ER Rep 259 at 267 that every man is entitled if he can to order his affairs so as to diminish the burden of tax. The limits within which this principle is to operate remain to be probed and determined judicially. Difficult though the task may be for judges, it is one which is beyond the power of the blunt instrument of legislation. Whatever a statute may provide, it has to be interpreted and applied by the courts; and ultimately it will prove to be in this area of judge-made law that our elusive journey's end will be found.'

The legislature in the Income Tax Act has defined the circumstances in which a liability for tax arises and if a taxpayer falls outside those circumstances, even if he designedly does so, he is not liable for tax. For example, a taxpayer may, in order to reduce his liability for tax, acquire investments, which produce income which the Act does not regard as gross income or which it exempts from tax. Again, there may be two methods of achieving the same financial result, one which results in tax being paid and the other not.

In *IRC v Wesleyan Assurance Society*⁸ Lord Greene MR stated the following:

'If one of these methods is adopted, tax will be payable. If the other method is adopted tax will not be payable ... The net result, from the financial point of view, is precisely the same in each case, but one method of achieving it attracts tax and the other method does not. There have been cases in the past where what has been called the 'substance of the transaction' has been thought to enable the court to construe a document in such a way as to attract tax. That particular doctrine of substance as distinct from form was, I hope, finally exploded by the decision of the House of Lords in *Duke of Westminster v Inland Revenue Commissioner*.'

But while this is the general rule, the taxpayer is not entirely free to arrange his affairs so as to pay the least tax, because the Act contains a general provision which enacts that he may be taxed as if the arrangement or transaction, which resulted in the taxpayer having no income subject to tax, had not been entered into which would nullify the tax benefit.

The transaction remains valid and enforceable between the parties to it, but for tax purposes the Commissioner may ignore it or counteract its tax effect in an appropriate manner. The section concerned is section 103 and, as is often the case with an anti-avoidance provision, its precise effect and ambit is a matter which occasions difficulty.

The three substantive anti-avoidance provisions are as follows:

- one dealing with arrangements and transactions in general which have the effect of avoiding, reducing or postponing liability for tax;
- the second dealing with the specific case of utilising a company's assessed loss for the purpose of avoiding, reducing or postponing liability for tax and;
- the third dealing with dividend and interest swaps.

⁸ (1948) 1 AER 555 (HL) at 557.

In *Glen Anil Development Corp Ltd v SIR*⁹ the court after referring to various authorities on the interpretation of fiscal statutes went on to say the following:

'In any event I do not understand the rule to be that every provision of a fiscal statute, whether it relates to the tax imposed or not, should be construed with due regard to any rules relating to the interpretation of fiscal legislation. Sec 103 of the Act is clearly directed at defeating tax avoidance schemes. It does not impose a tax, nor does it relate to the tax imposed by the Act or to the liability therefor or to the incidence thereof, but rather to schemes designed for the avoidance of liability therefor. It should, in my view, therefore, not be construed as a tax measure but rather in such a way that it will advance the remedy provided by the section and suppress the mischief against which the section is directed (*Hleka v Johannesburg City Council*, 1949 (1) SA 842 (A) at 852, and see generally Maxwell *Interpretation of Statutes*, 12 ed pp 40 *et seq*). The discretionary powers conferred upon the Secretary [now Commissioner] should, therefore, not be restricted unnecessarily by interpretation.'

In addition to the general provision there are a number of specific provisions designed to prevent tax avoidance. This report focuses solely on the general anti-avoidance section, as the specific anti-avoidance sections are outside its scope.

This report presents a simple, yet comprehensive synopsis of section 103(1) of the Act.

- First, the principles of interpretation of fiscal legislation are discussed, with particular attention awarded to the interpretation of anti-avoidance legislation.
- Secondly, section 103(4) of the Act, commonly referred to as the 'presumption' subsection, is evaluated.
- Thirdly, section 103(1) prior to the amendment is critically compared to the same section after certain amendments were made in 1996.
- Fourthly and finally, some miscellaneous provisions are discussed to conclude. In particular, section 103(6) is investigated along with its link to section 89*quat* of the Act.

⁹ 75 AD 715, 37 SATC 319.

Interpretation of fiscal legislation

The principle canon of interpretation in respect of taxation statutes, indeed of all statutes, often called the cardinal rule, is that the literal meaning must be applied. This is well reflected in two passages occurring in English cases, which have been approved by the South African courts.

The first is a *dictum* of Lord Cairns in the *Partington* case where he stated the following:¹⁰

'If the person sought to be taxed comes within the letter of the law, he must be taxed, however great the hardship may appear to the judicial mind to be. In other words, if there be an equitable construction, certainly such a construction is not admissible in a taxing statute.'

The *dictum* was approved and followed by De Villiers JA in the case of *CIR v George Forest Timber Co*¹¹ and has since been repeatedly referred to in the South African cases. It means that once the true meaning of a section is ascertained, if the taxpayer falls within that meaning he must pay.

The second passage is a *dictum* of Rowlatt J in *Cape Brandy Syndicate v IRC*,¹² which was approved of by Simon VC in *Canadian Eagle Oil Company v The King* where he stated the following:¹³

'(It simply means that) in a taxing Act one has to look merely at what is clearly said. There is no room for any intendment. There is no equity about a tax. There is no presumption as to a tax. Nothing is to be read in, nothing is to be implied. One can only look fairly at the language used.'

¹⁰ LR 4 HL 100 at 122.

¹¹ 24 AD 475, 1 SATC 20.

¹² (1921) 1 KB 64.

¹³ (1946) AC 199 at 140. The general principle, then, is that the literal meaning of the provisions of a taxation statute is decisive. There is no room for considerations of equity. The principle is clear, but its application may often be difficult. For, what is the literal meaning? The following remark of Schreiner JA in *Savage v CIR*¹⁴ is, with respect, very pertinent in this regard:

'So, too, what seems clear meaning to one man may not seem clear to another. This consideration must also, I think, be borne in mind where one refers to the literal, ordinary, natural or primary meaning of words or expressions. The "literal" meaning is not something revealed to judges by a sort of authentic dictionary; it is only what individual judges think is the literal meaning, if they employ that term.'

It is often said that a grammatical and logical construction must be placed on the words in a statute. The words must be read in the light of their popular, ordinary and natural sense but the context must not be ignored. But considerations, which may serve to interpret expressions, which are obscure or ambiguous, cannot be invoked so as to stigmatise words which are plain. The Act must be construed that, if it can be prevented, no clause, sentence or word becomes superfluous, void or insignificant, but, tautology in statutes being common, it may well be that the one or other of the words used is tautological.

The governing rule of interpretation is in general to try to ascertain the intention of the legislature from a study of the provisions in question, and what really matters is the intention of the legislature as expressed in the language of the Act. If, therefore, the language used by the legislature is both clear and intended, it cannot be departed from.

If the intention of the legislature is not expressed, there is a *casus omissus*, which cannot be supplied by the courts whose sole duty is to construe the Act as it stands. Apart from a *casus omissus*, is it possible to overcome what appears to be a discrepancy between the language used and the intention of the legislature by means of interpretation rules?

In case of doubt the *contra fiscum* rule must be invoked. This means that a doubtful, that is, ambiguous provision in a taxation statute must be construed against the larger imposition, or the benefit of the doubt must be given to the person sought to be charged, that is, the taxpayer. If the provision in question does not permit of any doubt, the rule cannot be applied.

The courts will not construe a taxing statute so as not to impose a burden by a process of allowing considerations of equity to create a supposed ambiguity which in fact does not exist, and it does not matter whether the provision in question is one charging tax or allowing for a deduction.

The *contra fiscum* rule does not apply to every provision of a fiscal statute. A *provision designed to prevent tax avoidance should not be construed as a taxing measure but rather in a way that it will advance the remedy provided by the section and suppress the mischief against which the section is directed.*

Section 103(4) of the Act

Section 103(4) reads as follows:

'Any decision of the Commissioner under subsection (1), (2) or (3) shall be subject to objection and appeal, and whenever in proceedings relating thereto it is proved that the transaction, operation, scheme, agreement ... would result in the avoidance or the postponement of liability for payment of any tax, duty or levy imposed by this Act or any previous Income Tax Act or any other law administered by the Commissioner, or in the reduction of the amount thereof, it shall be presumed, until the contrary is proved—

- (a) in the case of any such 'transaction, operation or scheme', that it was entered into or carried out solely or mainly for the purposes of the avoidance or the postponement of such liability or the reduction of the amount of such liability; or
- (b) ... '

(Irrelevant words omitted.)

On appeal to the court, the *onus* in general is upon the taxpayer to prove that the assessment is incorrect in terms of section 82, but section 103(4), which subjects any decision of the Commissioner under section 103 to objection and appeal, specifically deals with the question of *onus*. It provides that whenever in proceedings relating to an appeal under section 103 it is proved that the transaction, operation or scheme would result in the avoidance or the postponement of liability for payment of any tax, duty or levy imposed by the Act or any previous Income Tax Act or any other law administered by the Commissioner or in reduction of the amount thereof it shall be presumed, until the contrary is proved that, in the case of a transaction, operation or scheme, it was entered into or carried out solely or mainly for the purpose of such avoidance, postponement or reduction.

As the presumption only arises whenever it is proved that the avoidance, postponement or reduction of tax would result, it is considered that the *onus* of proving this lies upon the Commissioner.

Section 103(4) does not deal with the question where the *onus* lies in regard to the abnormality of the means by or manner in which a transaction is entered into or carried out, or in regard to the abnormality of the rights or obligations created. In *Hicklin's* case, the court, after observing that the problem of normality and abnormality was mainly a factual one, said the following:¹⁵

'The court hearing the case may resolve it by taking judicial notice of the relevant norms and standards or by means of the expert or other evidence adduced thereanent by either party. It is unnecessary to decide what happens if at the end of the day, because of the lack of its own knowledge or such evidence, the court cannot resolve the problem.'

It is submitted that the general onus provision found in section 82 as to *onus* does not apply to section 103 which contains its own provisions as to *onus* and that in the absence of provisions in section 103 casting the onus burden on the taxpayer, the *onus* of establishing abnormality lies on the Commissioner. It appears to have been so held in the unreported portion of the judgment in ITC 1151.¹⁶

If section 82 were otherwise applicable it would have been entirely redundant to make any provision in regard to *onus* in section 103, as the legislature has done. Since the test of normality is not something peculiarly within the knowledge of the taxpayer, there is no particular reason to think that the legislature did not intend that the Commissioner, who has to form an opinion as to 'abnormality', should establish the facts on which he bases that opinion.

¹⁵ 80 AD 481, 41 SATC 179.

¹⁶ 33

In *L v COT*,¹⁷ the intention of the taxpayer's accountants was imputed to the taxpayer. This means that the Commissioner need not prove that the 'purpose' criterion is present when invoking the provisions of section 103(1), that is, he need only be satisfied that the other three criteria are all present before invoking the section.

But the courts have held that for section 103(1) to successfully *apply*, all four criteria (discussed in detail in the next part of this report) must be present, and that if any one of them is absent the Commissioner will not be able to apply section 103(1).¹⁸

In *Hicklin's* case, the taxpayer was able to satisfy the court that the sale of shares to a sharedealer at a discount did not fall foul of section 103 in that it did not constitute an abnormal transaction.

The 'abnormality' requirements of the new and old section 103(1) are discussed in detail below.

In *Geustyn's* case, a company was formed in 1966 to take over the business of consulting engineers which had been carried on in partnership by Geustyn, Forsyth and Joubert. For the 1967 year of assessment, the company had a taxable income of R72 840 upon which normal tax payable would have been R29 136.

The Commissioner being of the opinion that the formation of the company was a scheme for the reduction of tax, applied s 103(1) and taxed the shareholders on the said income.

¹⁷ 75 AD 478, 37 SATC 116.

¹⁸ See in this regard; *SIR v Geustyn, Forsyth and Joubert* 71 AD 432, 33 SATC 113.

In deciding in favour of the taxpayer, the Appellate Division of the Supreme Court found that the avoidance of tax was not the sole or one of the main purposes of the conversion of the partnership into a company, and that the Commissioner could not rely on section 103(1) to tax the individual shareholders rather than the company.

It is important to note that the current wording of section 103(1) is solely or mainly, which is narrower than the sole or one of the main purposes as it appeared at the time when this case was decided. This could mean that it may be easier to successfully rebut the Commissioner's section 103(4) presumption under the current legislation.

In *SIR v Gallagher*,¹⁹ a taxpayer had formed a company, the shares of which were held by three trusts formed for the benefit of his three children. The reason for forming the company was because of the nature of his occupation and the growth in his assets. He then sold listed and unlisted investments to the company.

The Commissioner sought to tax Gallagher on the dividends accruing to the trust, in terms of section 103(1), on the grounds that the scheme had been entered into for the purpose of avoiding tax. At that stage, dividends were taxable.

The taxpayer contended that section 103(1) was not applicable because his sole or main purpose in forming the trusts had been estate planning and not income tax avoidance. The court accepted this contention and found in favour of the taxpayer. It should be noted that at the time of this case the purpose clause in section 103(1) referred only to income tax avoidance and not to the avoidance of any other levy administered by the Commissioner. Shortly after the decision in this case, section 103(1) was amended to widen the purpose clause to include any levy in terms of any Act administered by the Commissioner.

¹⁹ 78 AD 836, 40 SATC 39.

Under the current law, therefore, a scheme (with the necessary abnormal features) entered into to avoid estate duty (or any other levy collected by the Commissioner) would satisfy the purpose clause if it also resulted in a saving of a tax imposed by the Income Tax Act, even though this result may be unintentional.

The extension of the tax avoidance purpose has broadened the scope of section 103(1). The apparent reason for doing so was to overcome the situation where in consequence of transactions designed to save estate duty, income tax was also being saved, but the Commissioner could not invoke the section because income tax avoidance was not one of the main purposes.

It is worth noting that section 103(1) only provides a remedy against the income tax avoidance and not against the estate duty saving. It is submitted that if a general anti-avoidance section were to be inserted into the Estate Duty Act, estate planning schemes may then be vulnerable to attack by the Commissioner notwithstanding the fact that these schemes may not result in a saving of a tax imposed by the Income Tax Act.

Clearly, the unfortunate taxpayer against whom the Commissioner raises the provisions of s 103(1), has an onerous burden to defend the attack. If a taxpayer proves that a transaction was not entered into solely or mainly for the purposes of tax avoidance, it seems to be an effective blow to the Commissioner which usually results in the taxpayer emerging victorious.

Section 103(1) prior to the 1996 amendment

Section 103(1) used to read as follows:

'Transactions, operations or schemes for purposes of avoiding or postponing liability for or reducing amounts of taxes on income.'-(1) Whenever the Commissioner is satisfied that any 'transaction, operation or scheme' (whether entered into or carried out before or after the commencement of this Act, and including a 'transaction, operation or scheme' involving the alienation of property);

- (a) has been entered into or carried out which has the effect of avoiding or postponing liability for the payment of any tax, duty or levy imposed by this Act or any previous Income Tax Act, or of reducing the amount thereof; and
- (b) having regard to the circumstances under which the 'transaction, operation or scheme' was entered into or carried out;
 - (i) by means or in a manner which would not normally be employed in the entering into or carrying out of a 'transaction, operation or scheme' of the nature of the 'transaction, operation or scheme' in question; or
 - (ii) has created rights or obligations which would not normally be created between persons dealing at arm's length under a 'transaction, operation or scheme' of the nature of the 'transaction, operation or scheme' in question; and
- (c) was entered into or carried out solely or mainly for the purpose of the avoidance, postponement, or the reduction in the amount, of liability for payment of any tax, duty or levy, whether imposed by the Act or any previous Income Tax Act or by any other law administered by the Commissioner.

the Commissioner shall determine the liability for any tax, duty or levy imposed by this Act, and the amount thereof, as if the 'transaction, operation or scheme' had not been entered into or carried out, or in such manner as in the circumstances of the case he deems appropriate for the prevention or diminution of such avoidance, postponement or reduction.'

The important aspects of section 103(1) are summarised as follows:

- There must be an avoidance, reduction or postponement of a liability to pay tax levied in terms of the Income Tax Act.
- The avoidance must be as a result of a 'transaction, operation or scheme'.
- The necessary 'abnormal' features must be present.
- The scheme must have been solely or mainly to avoid any levy administered by the Commissioner.

The four prerequisites are commonly known as the:

- 'transaction',
- 'effect',
- 'abnormality' and,
- 'purpose'

requirements.

These prerequisites are not discussed in the above order in this report. The discussion below follows the order as they appear in the legislation.

Looking closely at the opening words of the section, there appears to be an initial onus on the *Commissioner* to raise the provisions of section 103(1) when he is satisfied that three of the four criteria are present, since he may presume that the 'purpose' of the 'transaction, operation or scheme' was tax avoidance until it is proved otherwise by the taxpayer (see above under the section 103(4) discussion).

The first requirement in the section is that there must be a 'transaction, operation or scheme'. It is worth noting that the 'transaction, operation or scheme' could have taken place before the Income Tax Act was originally promulgated. Anti-avoidance sections usually do contain this type of language and tone for obvious reasons. Yet, these words seem irrelevant from a practical point of view.

The ultimate step in a scheme need not be in contemplation from the outset; it may be decided upon later and if there is sufficient unity between the steps, having regard to the ultimate objective, they may together be regarded as being part and parcel of a single scheme.²⁰

In ITC 1274,²¹ the court held that the Commissioner's representative was precluded from arguing the applicability of section 103(1) if the Commissioner had not formed an opinion on the various matters. It is submitted that the Commissioner is required to be satisfied on the various matters before making the assessment and that the taxpayer should be advised (in the assessment notice or other appropriate manner) that the Commissioner has applied section 103(1).²²

Transactions involving the alienation of property are specifically included as one of the types of transactions to which the section could apply. It is submitted that a donation, settlement or any other similar disposition of any property, for example, a gift of property, could constitute the alienation of property as contemplated by the section.

²⁰ See *CIR v Louw* 83 AD 551, 45 SATC 113.

²¹ 40 SATC 185.

²² See *Natal Estates v CIR* 75 AD 93, 37 SATC 193.

The legislature, no doubt, intended for the first requirement of section 103(1) to be extremely wide so as to cover all possible transactions whether in a business context or not. It is submitted that the first requirement of section 103(1) will always apply, that is, the taxpayer should not even attempt to argue that this requirement has not been satisfied because the Commissioner should always be able to prove this requirement exists.

The only situation where this requirement will not be present is where the taxpayer has remained dormant, that is, where the taxpayer has not engaged in any 'transaction, operation or scheme'. But this seems absurd since the Commissioner would not even have considered section 103 in those circumstances, for example, a dormant subsidiary within a group of companies with absolutely no commercial activity within a particular year of assessment.

The second requirement in the section is that the 'transaction, operation or scheme' entered into or carried out must have the effect of avoiding or postponing the liability for the payment of any tax, duty or levy imposed by the Income Tax Act or any previous Income Tax Act. This requirement is also satisfied if the amount of the tax properly chargeable has been reduced by the implementation of the 'transaction, operation or scheme'.

It is worth noting that the current section 103 is not limited to the Income Tax Act of 1962 since the wording specifically includes the avoidance of any tax under any previous Income Tax Act. But, these situations are almost non-existent in practice.

The taxes imposed by the current Income Tax Act are the following:

- Normal Tax.
- Secondary Tax on Companies.
- Donations Tax.

The 'transaction, operation or scheme' must have the effect of avoiding, postponing or reducing one of the above three taxes in order for the 'effect' requirement of section 103 to be satisfied. Where section 103(1) applies, whichever of these taxes are relevant to the case can be levied on the taxpayer.

Non-resident shareholders' tax, undistributed profits tax and the levy on financial services no longer form part of the current Income Tax Act.

The other laws administered by the Commissioner are:

- the Estate Duty Act,
- the Value-Added Tax Act,
- the Transfer Duty Act,
- the Stamp Duties Act,
- the Tax on Retirement Funds Act and,
- the Marketable Securities Act.

Where the relevant 'purpose' is present in relation to any of these Acts and the other conditions of section 103(1) are present, it will enable the Commissioner to apply the section to assess the taxpayer for any of the taxes mentioned above which may have been avoided, postponed or reduced. Section 103(1), it should be noted, does not give the Commissioner the power to void the transaction in relation to the taxes or duties referred to in this paragraph.

Any decision by the Commissioner in respect of any of the provisions set out above is subject to objection and appeal. This appeal is a hearing of the case by the Special Court which may substitute its own decision for that of the Commissioner.

The wording in the second requirement has a wide connotation suggesting that the legislature, no doubt, also intended for the second requirement of section 103(1) to be extremely wide so as to cover all possible transactions, whether in a business context or not.

It is submitted that the second requirement of section 103(1) will apply in most instances since it will not be too difficult for the Commissioner to prove that one of the taxes imposed by the Income Tax Act have been avoided, postponed or reduced as a result of the taxpayer implementing the 'transaction, operation or scheme' in question.

In *Smith v CIR*²³ the court felt that the necessary 'abnormal' features were present. The court also felt that the transaction concluded by the taxpayer had the effect of postponing, reducing or avoiding the liability for tax. In addition, the court found that the sole or main purpose of the transaction was to avoid, postpone or avoid tax on dividends. (At the time of this case, dividends were subject to tax in the hands of the shareholder.)

The taxpayer held shares in a South African company. As a result of a series of transactions the taxpayer became the sole shareholder in a South West African company which in turn held all the shares in a Rhodesian company which held, indirectly, the shares in the South African company. But for this structure, dividends would have accrued to him and not to the company. It was common cause that the transaction was both abnormal and had the purpose of avoiding tax.

²³ 64 AD 324, 26 SATC 1.

The Commissioner, included in the taxpayer's income a dividend which had originally been declared by the South African company and had eventually reached the South West African company through the chain of companies.

Smith objected to this assessment on the ground that the dividend paid to the Rhodesian company could never have been his and that there was, therefore, no avoidance of tax.

The Appellate Division overruled his subsequent appeal on the ground that tax avoidance meant 'to get out of the way of or prevent or escape anticipated liability'. The court felt that were it not for the 'scheme' the dividend from the South African company *would have* accrued to Smith, and that the Smith's effective control of the group of companies *would* enable him to ultimately receive the dividend.

It follows from this judgment that where any 'transaction, operation or scheme' (including the alienation of any asset) causes income to accrue to another person which would otherwise have accrued to the taxpayer, the 'effect' requirement in the section will probably be satisfied. This requirement will be satisfied because the 'transaction, operation or scheme' would have the effect of avoiding, postponing or reducing the taxpayer's liability to tax even though the taxpayer has no right to and will receive no benefit from the income as a result of the 'transaction, operation or scheme'.

In *Hicklin's* case, the court pointed out that a liability for tax may vary from an imminent certain prospect to some vague, remote possibility, but found it unnecessary to decide whether a vertical line should be drawn somewhere along that wide range of meanings in order to delimit the connotation of an 'anticipated liability'. In this case, the shareholders had sold their shares in a dormant company that had undistributable profits.

The Appellate Division considered it sufficient to say the following:

'[T]he liability of appellant and the other shareholders to tax on Reklame's distributable profits, albeit a liability contingent upon their declaring them as dividends, was clearly "an anticipated liability" within the contemplation of s 103(1). After all they were always mindful that something unforeseen might occur that would compel them to declare them as dividends and incur the ensuing tax liability, as, for example, the early death of one of them. And, as will presently appear, the possibility of some such contingency occurring was sufficiently proximate and pressing to induce them to sell their shares under the RN agreement in order "to get out of the way, escape or prevent" such liability from falling on them. The RN agreement undoubtedly had the effect of avoiding that anticipated tax liability of theirs.'

Where the income, which accrues to another, is the fruit of the taxpayer's capital or labour, this too is a method of avoiding a tax liability on behalf of a taxpayer. So, where the taxpayer and two others formed a company to produce a magazine and the company later sold its rights for a nominal sum to a partnership, of which a trust for the taxpayer's minor children was a partner instead of the taxpayer who continued to render editorial services for a small remuneration, it was held that the taxpayer avoided tax on income of the trust which was in its entirety the product of the taxpayer's personal labours.

The fact that the formation of the company had no tax avoiding purposes and that the rights were transferred not by the taxpayer but by the company was regarded as not being material in the circumstances where the taxpayer provided his personal labours.²⁴ In ITC 963 ²⁵ the taxpayer transferred funds from the Republic to South West Africa and invested them in South West Africa with the result that the income from this investment accrued from a source outside the Republic.

²⁴ See in this regard; *Meyerowitz v CIR* 63 AD 863, 25 SATC 287.

²⁵ 24 SATC 705.

It was held that by so doing the taxpayer did not avoid liability for tax. This judgment is correct and the reasoning is in accordance with *CIR v King*²⁶ but the reasoning is not applicable in the light of *Smith's* case.

It is not enough, for the application of section 103(1) that the transaction, operation or scheme has the effect of avoiding tax. The other requirements in the section must also all be satisfied for the section to successfully apply.

The third requirement in the section is that the 'transaction, operation or scheme' must either be entered into:

- in an 'abnormal' manner *or*,
- it must create 'abnormal' rights and obligations between the parties to the 'transaction, operation or scheme'.

The last requirement of the section is that the 'transaction, operation or scheme' was entered into or carried out solely or mainly for the 'purpose' of avoiding, postponing or reducing the liability for the payment of any tax, duty or levy imposed by this Act or any other Act administered by the Commissioner.

The word 'solely' would appear to be redundant since it is enough that the purpose is 'mainly' tax avoidance. Presumably it was introduced *ex abundanti cautela* to prevent an argument that where the sole purpose is tax avoidance, it cannot be termed a main purpose.

In *Geustyn's* case it was stated that 'purpose' as used in section 103(1) is used in the sense of the intention with which the transaction was entered into and not of the effect of the transaction.

²⁶

47 AD 765, 14 SATC 184.

That is, while the transaction may have the effect of avoiding tax, it does not follow that the purpose of entering into the transaction was to avoid, postpone, or reduce liability for tax. The test is a subjective one. Of prime importance in determining the purpose of the scheme would therefore be the evidence of the progenitor of the scheme as to why it was carried out.

The section also does not apply unless the tax avoidance purpose was the sole or main purpose. 'Mainly' (the Afrikaans version is 'hoofsaaklik') means 'for the most part; principally; chiefly'.²⁷ It conveys the idea of dominant, which was the meaning given in *King's* case, to the words 'the purpose' in the section before its amendment. In those days, the relevant phrase was 'solely or mainly'.

Consequently, even where tax avoidance is one of two or more purposes in entering into or carrying out a transaction, section 103(1) will not apply unless the tax avoidance was the dominant purpose. If it was the other purpose or one of the other purposes, which were decisive in bringing about the transaction, the fact that tax avoidance was a subsidiary or secondary purpose, will not empower the Commissioner to raise section 103(1).²⁸ If the scheme would have been entered into or carried out, irrespective of whether it had the effect of avoiding tax, then it is clear that tax avoidance is not a 'purpose' of the scheme yet alone the sole or main purpose.

For example, if a sale of an asset or the setting up of a company to take over a business is undertaken for purposes unconnected with tax avoidance, and faced with a choice of means to achieve this, a method is chosen which also has the effect of avoiding tax, the purpose in choosing this particular method would be subsidiary or incidental and not a main purpose.

²⁷ See Shorter Oxford Dictionary.

²⁸ See ITC 1307, 42 SATC 139.

Whether or not a transaction is subject to the provisions of section 103(1) must be answered by reference to the effect and purpose of the transaction and the circumstances surrounding it at the time it is implemented or carried out and not at the time it was formulated, that is, conceived, decided or agreed upon, or otherwise involved.

Therefore even if the purpose or effect of the scheme when it is formulated is not to avoid liability for tax, it may have that effect or that may become one of the taxpayer's main purposes when he subsequently carried it out.²⁹

In *Ovenstone's* case the taxpayer decided in 1966 to sell shares in a South West African company to a trust he was to create. The purchase price was to be settled out of the proceeds from an interest-free loan. His purpose was to save estate duty. At that time dividends on the shares were exempt from tax in South Africa, but when the scheme was implemented in 1969 dividends on the shares had become taxable in South Africa. The court held that the taxpayer had not discharged the *onus* of proving that the avoidance of income tax was not one of his main purposes in 1969 when he implemented his scheme.

The facts in the *Meyerowitz*³⁰ case are somewhat complex but briefly the taxpayer had the right to a share of profits from a publication. In terms of an agreement he ceded this interest to a company jointly owned by his wife and himself. A trust was then formed for the benefit of his children to whom the company ceded its rights. The result was that the income from the publication no longer flowed to the taxpayer but to his children instead.

²⁹ See *Ovenstone v CIR* 80 AD 721, 42 SATC 55.

³⁰ 63 AD 863, 25 SATC 287.

The Appellate Division found that the taxpayer had diverted income from himself to his children and that this had been done for the sole or main purpose of avoiding tax. The court considered it abnormal for the appellant to charge a low editorial fee for his services to the trust. The income was therefore correctly assessed to tax in the taxpayer's hands. The income of the trust was considered by the court to be a product of the appellant's work or labour. The court was accordingly entitled to regard the income which was rightfully the appellant's income as having been diverted from the appellant to his children by means of an artificial or abnormal 'transaction, operation or scheme'.

In *Louw's*³¹ case, a firm of civil engineers decided to sell their business to an incorporated company owned by them. As a result of this incorporation in 1966, profits, which had previously accrued to the taxpayer by way of salary and drawings from the partnership, accrued to the newly formed company.

A portion of these profits was paid to the taxpayer as a salary while the balance was drawn from the company by way of loan account. It is important to note that the shareholders had loan accounts to their credit in the newly formed company as a direct result of the sale of their business to the incorporated entity.

Exercising powers under section 103(1), the Commissioner sought to tax the shareholder (who had previously been a partner) on the profits accruing to the company. As companies paid tax at a lower rate than the maximum rate for individuals at that time, the formation of the company had the effect of reducing tax payable on fees earned for professional services rendered.

³¹ 83 AD 551, 45 SATC 113.

The taxpayer had successfully appealed against the assessment in the Special Court and it was against that decision that the Commissioner appealed to the Appellate Division.

The respondent and his partners had decided to incorporate their business in 1966. The partnership business was sold to the company at a determined figure (including goodwill) and payment was made partly by an issue of shares and partly by crediting loan accounts. These credit loan accounts were repaid in full and when further payments were made to the directors their loan accounts went into *debit* in about 1972.

By 1976 the respondent's debit loan account stood at R266 702 (the total loan accounts for all directors at that stage amounted to R1 253 867). The court noted that the amount, which accrued to the respondent by way of salary and dividends after incorporation, was substantially lower than the income, which had previously accrued to him from the partnership.

As a result of the decision in *Geustyn's*³² case, the facts of which were similar to this case, the Commissioner initially assessed the respondent only on income received by him from the company. In 1978, the Commissioner, however, issued revised assessments in terms of which he taxed the respondent on a proportionate share of the company's income. These 'revised' assessments were the subject of the appeal.

In applying section 103(1) to the facts of this case, the court found that there were in fact two schemes, namely;

- the incorporation of the business initially and,
- the making of loans to the shareholders subsequently which caused shareholders' loan accounts to go into debit.

³² See in this regard; *SIR v Geustyn, Forsyth and Joubert* 71 AD 432, 33 SATC 113.

Having drawn this distinction, the court then went on to examine each of the schemes in the context of section 103(1). In the case of the first scheme, that is, the incorporation, the court held that section 103(1) did not apply. It is interesting to note that this is in line with the decision in *Geustyn's* case.

In dealing with the directors' 'debit' loan accounts, the court found that the making of the loans constituted a scheme which had the effect of avoiding tax, which was 'abnormal' and which was entered into solely or mainly to avoid tax therefore section 103(1) applied.

The 'debit' loan accounts were considered 'abnormal', because the company did not ensure that they were repayable, nor did the company ask for any security from the directors.

In addition, the court held that had the loans not been made the directors would probably have received the equivalent in salary or dividends and that this was sufficient to show that the effect of the loans was to avoid or postpone liability for tax.

The court in *Louw's* case commented on the *special relationship* between the erstwhile partners and the company, which they formed in the following manner:³³

'In such a case should the court, in applying the 'normality' yardstick, take account of the special relationship between the erstwhile partners and the company which they have formed, or ignore it and apply the yardstick as though the company were a stranger? I do not see how the court can ignore this *special relationship* and yet give proper effect to the concluding words of s 103(1)(ii), viz. "under a 'transaction, operation or scheme' of the nature of the 'transaction, operation or scheme' in question ...". (My italics.)'

³³ 83 AD 551, 45 SATC 113.

The court in *Louw's* case went on to say the following:

'For it is of the very nature of the incorporation scheme that the company to which the practice is sold by the partners will have as its shareholders and directors the self-same partners and will be controlled by them. Those are the realities of the situation. Moreover, it must be borne in mind that in a case such as the present the transaction is a multipartite one to which all the partners and the company are parties; and each partner contracts both with the company and his fellow partners and seeks to extract from the transaction the best possible advantage for himself. (Here I might point out that this case differs from *Hicklin's* case *supra* in that there the Court was considering (see 494H-495F) an agreement which was entered into by parties dealing with one another at arm's length and the remarks of *Trollip* JA, particularly at the top of 495, must be read in the light of that fact.)

With this in mind, it does not seem to me that the features stressed by the appellant's counsel constitute the creation of abnormal rights or obligations.

As to the arrangement that the payment of the purchase price was to be made only as and when the company was in a financial position to do so, there is little else that the parties could have done. Initially the company had very limited capital and the idea was that it would pay off the purchase price out of profits. This it proceeded to do over a period of five to six years. Since the sellers were the persons mainly instrumental in earning those profits and were in complete control of the company, it was a perfectly sound and businesslike arrangement. It was not an arrangement that would not normally have been created by persons dealing at arm's length in this type of transaction.

The same goes for the non-payment of interest on the purchase price. The non-payment of interest increased the profits of the company; and this directly benefited the erstwhile partners as shareholders in the company for it enabled the company to pay off the purchase price more rapidly. Likewise, in the particular circumstances, there was, in my view, no abnormality in the fact that the erstwhile partners gave their services to the company for no previously stipulated salaries. As controllers of the company they were able from year to year to determine in their own interests what their salaries were to be. The fact that in the tax years under review – and in previous years, it would seem – respondent received a salary which was smaller than his income as a partner had been was again a matter of his own choice, in consultation with his co-directors and co-shareholders.'

(Emphasis added.)

Subsequent to the incorporation of the company, but independently thereof, as the court found, the credit loans having been exhausted, the company lent the shareholders large sums of money out of profits:

- free of interest and,
- without security and,
- without any definite conditions of repayment.

In the circumstances of the case it was held that the directors' 'debit' loan accounts, seen in the context of the amounts allocated to directors by way of salary and dividends, were abnormal both:

- as to the means or manner employed in granting them and,
- as to the rights and obligations created thereby.

The finding of the court that the loans by the company to its shareholders were abnormal both in regard to the means or manner and the rights and obligations created indicates the difficulty and maybe also the hazard in determining what is normal or abnormal having regard to the circumstances in relation to the nature of the transaction, operation or scheme in question. Despite the special relationship between the erstwhile partners and the company, which they had formed and which, the court had found, could not be ignored, it did not stop the 'debit' loan accounts from being regarded as being abnormal.

The arm's length test is hardly appropriate to a donation, but this does not mean that every donation is abnormal for the purpose of section 103, because the test must be applied to the transaction under consideration by reference to a transaction of a similar nature. That is, one must take cognisance of the nature of the transaction.

If added to the circumstances, there is an element of bounty to the transaction (where it is not a donation), this should not be fatal where the circumstances are such that this could be expected, for example, an interest-free loan between relatives.

The difficulty in accepting personal relationships as a relevant factor is that it could effectively emasculate the provisions of section 103 as to abnormality, since anything 'abnormal' could be explained by the special relationship existing between the parties. This special relationship was accepted as a relevant factor in regard to the Australian tax avoiding section by the Privy Council in *Newton v CoT*.³⁴ In *Ovenstone's* case, where a personal relationship did exist, counsel for the taxpayer did not contest the abnormality issue, and the court concluded that he had acted wisely.

In terms of section 103(3) whereby any person who is ordinarily resident or carrying on business in the Republic or any company registered or carrying on business in the Republic, has disposed of shares held by such person or company in any company registered or incorporated in the Republic to any person not ordinarily resident nor carrying on business in the Republic or to any company registered outside the Republic, the transaction, operation or scheme shall, unless it is proved to the satisfaction of the Commissioner that the parties were independent persons dealing at arm's length with each other, is deemed to be an abnormal transaction.

³⁴ (1958) 2 A11 ER 759 (PC).

If the parties are connected persons, that is, if there exists a special relationship between the parties to the transaction, the court must give full effect to this special relationship when considering whether the 'transaction, operation or scheme' has the necessary 'abnormal' features.

It is submitted that parties which have a special relationship between themselves can enter into blatantly 'abnormal' transactions with the effect of creating abnormal rights and obligations between themselves and successfully resist any section 103(1) attack, despite the fact that the section specifically caters for this type of situation, because the Commissioner will always have to recognise their special relationship.

In *Hicklin's* case, the appellant and his two co-shareholders sold their dormant company to a dividend-stripping company. The only asset in the dormant company was the loan to its shareholders. The purchase price of the company was equal to the net asset value of the company, less 10% of its distributable reserves.

Once the dividend-stripper had obtained control of the dormant company, it declared the distributable reserves as a dividend and thereafter deregistered the company.

Because the dividend-stripper was a company, and therefore not liable for tax on the dividend, the Commissioner applied section 103(1) and taxed Hicklin and his co-shareholders on the dividend. At that stage, individual shareholders were not exempt from normal tax on dividends that were received by or accrued to them.

The court held that the 'transaction, operation or scheme' was the sale of the shares to the dividend-stripper.

The purpose of the sale was to dispose of the dormant company, which had become a burden. The appellant had not, however, discharged the onus of showing that tax avoidance was not one of the main purposes of the sale. Had he liquidated or deregistered the company himself, he and his co-shareholders would have been taxed on the distributable reserves (a dividend as defined) as a dividend. The sale of the company therefore resulted in no dividend accruing to him.

The agreement between the sellers and the dividend-stripper was an arm's length transaction in which each party was striving to obtain the maximum possible advantage for himself. In an arm's length transaction, there is a (rebuttable) presumption that the rights and obligations created are normal and the means and manner employed are also likely to be normal. For this reason, the court felt that the 'abnormality' requirement was not satisfied and that section 103(1) was not applicable.

The court in *Hicklin's* case referred to arm's length transactions and stated the following:³⁵

'I turn now to consider this latter, crucial part of the problem – whether requirement (c) in s 103(1)(i) or (ii) relating to normality was fulfilled. A few preliminary observations about paras (i) and (ii) of the subsection. When the "transaction, operation or scheme" is an agreement, as in the present case, it is important, I think, to determine first whether it was concluded "at arm's length". That is the criterion postulated in para (ii). For "dealing at arm's length" is a useful and often easily determinable premise from which to start the enquiry. It connotes that each party is independent of the other and, in so dealing, will strive to get the utmost possible advantage out of the transaction for himself. Indeed, in the Afrikaans text the corresponding phrase is "die uiterste voorwaardes beding". Hence, in an arm's length agreement the rights and obligations it creates are more likely to be regarded as normal than abnormal in the sense envisaged by para (ii). And the means or manner employed in entering into or carrying it out are also more likely to be normal than abnormal in the sense envisaged by para (i). The next observation is that, when considering normality of the rights or obligations so created or of the means or manner so employed, due regard has to be paid to the surrounding circumstances.'

³⁵

80 AD 481, 41 SATC 179.

The court in *Hicklin's* case went on to say the following:

'As already pointed out s 103(1) itself postulates that. Thus, what may be normal because of the presence of circumstances surrounding the entering into or carrying out of an agreement in one case may be abnormal in an agreement of the same nature in another case because of the absence of such circumstances. The last observation is that the problem of normality or abnormality of such matters is mainly a factual one. The court hearing the case may resolve it by taking judicial notice of the relevant norms or standards or by means of the expert or other evidence adduced thereon by either party. It is unnecessary to decide what happens if at the end of the day, because of the lack of its own knowledge or such evidence, the court cannot resolve the problem.'

But, the parties to a transaction are not always at arm's length. Indeed it is often the case when the application of section 103 is in question that they are not; for example, they may be relatives of the taxpayer, or shareholders of a company taxpayer.

Is this feature, that of the parties not being arm's length, one of the circumstances to which regard must be had in determining the normality of the transaction? The difficulty is reflected in the following passage from *Geustyn's* case.

In that case a professional partnership had converted to an unlimited liability company with the the partners as the shareholders of the 'new' company. They were credited with R240 000 goodwill on which interest was payable, but took no security for payment. They each received a salary and directors' fees which together with interest on their loan accounts was less than the amount they would have earned as partners. They did not have service contracts with the company. The Commissioner contended that the cumulative effect of these facts revealed that the transaction had not been carried out in a normal manner and had created rights and obligations, which would not normally be created by persons dealing at arm's length.

Of this contention the court in *Hicklin*'s case said the following:

'Section 103(1) is couched in very comprehensive terms but in forming his opinion ... the Commissioner is required to have regard to the circumstances under which the transaction, operation or scheme was entered into or carried out. The criterion of "persons dealing at arm's length, mentioned in section 103(1) (ii) is, however, not easy of application in a case such as the present. For the section enjoins the application of that criterion in relation to a transaction, operation or scheme in question". Yet the Court is in the present case *ex hypothesi* concerned with partners who have, in the circumstances outlined above, made over their practice, not to an independent third party with whom they would ordinarily deal "at arm's length", but to an unlimited liability company of which they are the sole directors and whereof they have full and complete control. However, inasmuch as it is not essential for the decision of this case to pronounce upon the particular aspect of the matter (which was not exhaustively argued before us), I prefer to express no conclusion upon the point.'

From the above it seems that, as long as the parties are dealing at arm's length, because of the very nature of this type of transaction, the necessary 'abnormal' features will almost always never be present, because each party will be striving for the best possible advantage to himself from the transaction.

It seems that the necessary 'abnormal' features will not be present in terms of the 'old' section 103(1) in respect of the following:

- Arm's length transactions.
- Transactions between connected parties.

Accordingly, although a particular 'transaction, operation or scheme' is entered into solely or mainly for the purpose of tax avoidance and which has the effect of avoiding, postponing or reducing tax, any attack by the Commissioner will be unsuccessful using the 'old' section 103(1) as the basis for the attack, irrespective of whether the transaction is concluded between strangers or connected parties.

This is because the 'abnormality' requirement will not be present. It follows, therefore that prior to the 1996 amendment, no 'transaction, operation or scheme' entered into by a taxpayer with the sole or main purpose of tax avoidance was susceptible to a section 103(1) attack by the Commissioner. The section was therefore an ineffective anti-avoidance section. This gave taxpayers the opportunity to experiment with creative and elaborate tax avoidance schemes.

If the Commissioner was successful in raising the 'old' s 103(1) against a taxpayer, the Commissioner would, in most instances, simply ignore the taxpayer's 'transaction, operation or scheme', that is, set it aside, and assess the taxpayer to tax as if he had not entered into the 'transaction, operation or scheme' to avoid, escape or avoid tax.

But if the circumstances of the case warrant an alternative response by the Commissioner, he may tax the taxpayer in any appropriate manner in order to prevent the avoidance, postponement or reduction of liability for tax. This means that the Commissioner does not always have to ignore the transaction in its entirety – he may choose the alternative response available to him in terms of the section. Any decision of the Commissioner under the alternative response is subject to objection and appeal.

In *Newton's case*³⁶, the Privy Council said that the Australian tax avoidance section – which provides that the arrangement is void against the Commissioner – was an annihilating one and that it was not enough to ignore the transactions which had the effect of tax avoidance; the ignoring of the transactions did not of itself create a liability for tax – the Commissioner had to find the income in the hands of the taxpayer.

³⁶ (1958) 2 A11 ER 759 (PC).

In the *Meyerowitz*³⁷ case, the court held that the alternative provision allowing the Commissioner to tax in such manner as in the circumstances of the case he deems appropriate distinguished the South African section from the Australian section. The Appellate Division did not discuss the full ambit of the alternative provision, but said that in the circumstances of the case it was appropriate for the Commissioner to have taxed the income in the hands of the taxpayer to whom it in reality belonged, that is, in the sense that it was the product of his labour.

In *H v COT*, it was said that the Commissioner:³⁸

'may, if he wishes, pull down the whole artificial edifice which has been erected by the taxpayer for the purpose of avoiding tax, but if in the circumstances it is not appropriate to do that, he can pull down part of that edifice and tax on the basis that that part of the edifice had never existed, while at the same time leaving in existence another part of the edifice and accept tax from that part as if that part was a legitimate structure in the taxpayer's income to double income tax, because were he to do this he would not be acting in a fair and appropriate manner, as this section is not a penal one.'

In that case the scheme involved passing profits through a chain of companies, and what the Commissioner did was to 'cut the pipeline' with the result that for the purpose of income tax the profits did not reach the further companies in the chain as income.

A situation could arise where s 103(1) is invoked subsequent to the year in which the relevant income had accrued to and been taxed in the hands of the recipient, for example, in the hands of a company or a beneficiary under a trust.

³⁷ 63 AD 863, 25 SATC 287.

³⁸ 72 AD 478, 34 SATC 39.

It would be open for the Commissioner to assess the taxpayer for the full amount and refund the tax previously exacted from the recipient of the income, or to allow the taxpayer a credit against his tax liability of the amount of tax paid on the relevant income by the recipient.

The first course may not be open to the Commissioner if three years or more from the date of assessment on the recipient has elapsed, but is it open to the Commissioner, in the situation referred to, to use section 103(1) to levy the taxpayer with tax on the full amount involved without making any adjustment in respect of the tax already paid.

It is considered that while it is within the Commissioner's discretion to decide upon the manner in which he may tax in order to prevent tax avoidance, failure to make appropriate adjustments to avoid taxing the same income twice, would not be acting appropriately as required by the section.

In *Louw's* case, the court said that, while the Commissioner was entitled to re-open the taxpayer's assessment, notwithstanding that the same income had been taxed in the hands of the company, the Commissioner may not tax the same income twice. Equity demanded that in applying section 103(1), the Commissioner should either:

- make due allowance, where this is appropriate, for the tax already paid by the company or,
- he should re-open and make a fitting adjustment to the company's assessments.

The Katz Commission 'discovered' this deficiency in the general anti-avoidance section in the Act and proposed an amendment³⁹, which was legislated in 1996. The effects of this amendment are discussed below.

³⁹ The Revenue Laws Amendment Act 46 of 1996.

Section 103(1) after the 1996 amendment

The amended section reads as follows:

(The provisions of this section as amended.)

'103. Transactions, operations or schemes for purposes of avoiding or postponing liability for or reducing amounts of taxes on income.-(1) Whenever the Commissioner is satisfied that any 'transaction, operation or scheme' (whether entered into or carried out before or after the commencement of this Act, and including a 'transaction, operation or scheme' involving the alienation of property):

(a) has been entered into or carried out which has the effect of avoiding or postponing liability for the payment of any tax, duty or levy imposed by this Act or any previous Income Tax Act, or of reducing the amount thereof; and

(b) having regard to the circumstances ~~under which the 'transaction, operation or scheme' was entered into or~~ carried out:

(iii) was entered into or carried out-

(aa) in the case of a 'transaction, operation or scheme' in the context of business, in a manner which would not normally be employed for *bona fide* business purposes, other than the obtaining of a tax benefit; and

(bb) in the case of any other 'transaction, operation or scheme', being a 'transaction, operation or scheme' not falling within the provisions of item (aa), by means or in a manner which would not normally be employed in the entering into or carrying out of a 'transaction, operation or scheme' of the nature of the 'transaction, operation or scheme' in question; or

(iv) has created rights or obligations which would not normally be created between persons dealing at arm's length under a 'transaction, operation or scheme' of the nature of the 'transaction, operation or scheme' in question; and

(c) was entered into or carried out solely or mainly for the purposes of obtaining a tax benefit,'

The section goes on to read as follows:

'[T]he Commissioner shall determine the liability for any tax, duty or levy imposed by this Act, and the amount thereof, as if the transaction, operation or scheme had not been entered into or carried out, or in such manner as in the circumstances of the case he deems appropriate for the prevention or diminution of such avoidance, postponement or reduction.'

The fundamental structure of the section does not appear to have changed.

Two situations or types of transactions are now envisaged in the new section and a tax benefit is defined within section 103. This definition is found in section 103(7) of the Act and also in section 73(2)(d) of the Value-Added Tax Act (since its date of promulgation).

A 'tax benefit' is defined as including any avoidance, postponement or reduction of liability for payment of any tax, duty or levy imposed by the Income Tax Act or any other law administered by the Commissioner, for example, the Estate Duty Act, the Value-Added Tax Act, the Stamp Duty Act and the Transfer Duty Act.

Section 103(6) was also inserted into the Act in 1996 to compel the Commissioner, in situations where section 103(1) is successfully applied against the taxpayer, to charge interest under section 89*quat* on the tax that would have been payable had the taxpayer not embarked on a 'transaction, operation or scheme' to avoid tax. Section 89*quat* is discussed in the last section of this report.

Under the 'old' section 103, all transactions were subject to the same two 'abnormality' tests:

- If the transaction was entered into in an abnormal manner *or*,
 - created abnormal rights or obligations between the parties concerned,
- the 'abnormality' requirement was satisfied.

Under the amended section 103, two types of transactions are envisaged, namely:

- transactions in the context of business and,
- those that are not in the context of business.

There is no definition of 'business' in the Act. There is, however, a definition of 'trade' in section 1 of the Act. This definition reads as follows:

' "trade" includes every profession, trade, *business*, employment, calling, occupation or venture, including the letting of any property and the use of or grant of permission to use any patent as defined in the Patents Act, 1978 (Act 57 of 1978), or any design as defined in the Designs Act, 1967 (Act 57 of 1967), or any trade mark as defined in the Trade Marks Act, 1963 (Act 62 of 1963), or any copyright as defined in the Copyright Act, 1978 (Act 98 of 1978), or any other property which is of a similar nature;'

(Emphasis added.)

In ITC 1179,⁴⁰ it was said that the words 'carrying on business' must be given their ordinary meaning in the commercial sense.

⁴⁰ 35 SATC 38.

The court referred to the case of *Estate G v COT*⁴¹ in which Beadle CJ stated that in order to determine whether a business is being carried on:

- the nature, scope and magnitude of the taxpayer's activities,
- the object (whether to make a profit or not) and,
- the continuity of the activities concerned

would have to be taken into account.

In *Stephan v CIR*⁴² Mason J stated that 'carrying on business' does imply a series of transactions. He distinguished trade and business from 'acts of amusement or the ordinary incidents of domestic life'.

In *Platt v CIR*, Jutta JA referred to the English case of *Smith v Anderson*⁴⁴ in which 'business' was defined as follows:⁴³

'Anything which occupies the time and attention and labour of a man for the purpose of profit.'

It is interesting to note that in the United Kingdom case of *Ransom v Higgs*,⁴⁵ Lord Reid said that the word 'trade' is commonly used to denote operations of a commercial character by which the trader provides to customers for reward some kind of goods or services.

⁴¹ 64 AD 303, 26 SATC 168.

⁴² 19 AD 203, 32 SATC 54.

⁴³ 37 AD 258, 32 SATC 142.

⁴⁴ 15 Ch D 258.

⁴⁵ 1974, 3 A11 ER 949.

In *Modderfontein Deep Levels v Feinstein* the following statement was made:⁴⁶

'To constitute a business there must either be a definite intention at the first act to carry on similar acts from time to time if opportunity offers, or the acts must be done not once or twice but successively, with the intention of carrying it on, so long as it is thought desirable.'

More recently the question of what constitutes the 'carrying on of a business' was considered in ITC 1529, where the question was whether the deriving of rentals constituted the carrying on of a business. Melamet J referred to the *Modderfontein* decision and stated the following:⁴⁷

'Indeed, if acts of that kind amounted to "carrying on business" it would not be possible to qualify for exemption. In essence, there is no difference where the investment takes the form of the purchase of immovable property. In that case, the acceptance of rent is as natural an incident of the investment as the acceptance of interest upon a loan of money. Where the investment takes that form, I do not suggest that rent received is not properly chargeable to tax. But the mere acceptance of the benefits normally associated with an investment of that kind do not, in more than in the case of an investment by way of loan, amount to "carrying on business". The problem is to decide whether on the findings of the Special Court, it can be said the deceased was "carrying on business".

The sensible approach, I think, is to look at the activities concerned as a whole, and then to ask the question: Are these the sort of activities which, in commercial life, would be regarded as "carrying on business"? The principal feature of the activities which might be examined in order to determine this are their nature, their scope and magnitude, their object (whether to make a profit or not), the continuity of the activities concerned, if the acquisition of property is involved, the intention with which the property was acquired. This list of features does not purport to be exhaustive, nor are any one of these features necessarily decisive, nor is it possible to generalise and state which feature should carry most weight in determining the problem. Each case must depend on its own particular circumstances.'

⁴⁶ 20 TPD 288, '32 SATC 202.

⁴⁷ 54 SATC 252.

'The appellant owned two adjoining stands constituting a single lettable unit which were let to an existing tenant in terms of a single agreement of lease for a number of years. He made no decisions in regard to the administration of the property and had no actions to take except to wait for the bank to remit the rental to him. Such circumstances and activities do not fall within the parameters of the considerations propounded on the above authorities for the carrying on of business, nor would they in commercial life be considered to be such and anything other than an investment in property with rentals being an incident thereof.'

Since 'business' is included in the definition of 'trade', it seems logical to conclude that if a taxpayer is carrying on a business, he must also be trading. Yet, if he is trading he may not necessarily be carrying on a business. But, the test in the recently amended section 103 is not whether the transaction under review is in the context of 'trade'.

The test is whether the transaction under review is in the context of business. The latter question seems far narrower than the former. It is crucial to be able to classify a transaction as being in the context of business or not. In the case of a non-business transaction, section 103 will be applied to the transaction in the manner discussed above, that is, before the 1996 amendment.

*Smith's*⁴⁸ case is a reputable test of 'carrying on business' and could be used when deciding whether a transaction is in the context of business or not for the purposes of s 103.

If a firm of professionals decided to sell their business to an incorporated company on loan account, it is relatively straightforward to conclude that this type of transaction is clearly in the context of business because it is so closely related to their profession, that is, their business. Their profession occupies their time, attention or labour with the object of making a profit.

⁴⁸ 64 AD 324, 26 SATC 1.

But, if a wealthy individual engaged in an estate planning exercise, sells all his growth assets to a generation skipping device, for example, a trust or limited liability company on loan account, it is not so straightforward to conclude that this type of transaction is in the context of business because it is not closely related to how he occupies his time, attention and labour with the object of making a profit.

It could be argued that an estate plan could also be seen as being in the context of business. Adopting a micro as opposed to a macro view of a transaction results in this conclusion.

When a taxpayer executes an estate plan, he is involved in a number of smaller, underlying transactions, for example:

- setting up a trust or company,
- drafting and executing purchase and sale agreements and,
- obtaining independent property valuations.

These transactions, when looked at in isolation, are transactions in the context of business notwithstanding the fact that an estate plan is not in itself, a transaction in the context of business.

If a Muslim taxpayer, in an attempt to comply with Islamic Law, withdraws all his money from the bank and places it under his mattress to avoid earning interest, can this transaction be seen to be in the context of business?

It seems hard to believe that a transaction of this nature could ever be regarded as being in the context of business. Yet, if a common parlance test is applied, by physically going into the bank and removing his funds, the taxpayer executed a normal business transaction.

When the courts are attempting to classify a transaction under section 103, a number of factors will be investigated:

- The intention behind the scheme,
- the taxpayer's trade,
- the common parlance interpretation,
- the surrounding circumstances and,
- the taxpayer's *ipse dixit*

will be the most important considerations.

At the time of writing this report, there had been no case law on the amended section 103. Taxpayers will have to wait for the courts to interpret this contentious piece of legislation in order to obtain some idea as to how the amendments are to be interpreted.

Attention needs to be directed toward transactions clearly in the context of business, entered into or carried out in a manner not normally employed in a *bona fide* business. That is, transactions concluded in an unusual business manner because the departure from *bona fide* business practice gave rise to a tax benefit. In these circumstances, the 'abnormality' requirement specific to business transactions will be met.

If a transaction is not considered to be a transaction in the context of business, there is no change in the test for 'abnormality', that is, the two 'old' tests discussed above in the previous section apply.

Under the 'new' section 103, the transaction (whether in the context of business or not) must still have the effect of postponing or avoiding liability for the payment of any tax, duty or levy imposed by the Income Tax Act or of reducing the amount of tax payable under the Act. This requirement within section 103 has remained unchanged. In addition, there still needs to be a

'transaction, operation or scheme' and the transaction must have been entered into or carried out solely or mainly for the purposes of obtaining a 'tax benefit'.

It is submitted that the insertion of the term 'tax benefit' into the 'new' section 103 has had no material impact on the section other than to prevent the principle wording in the section from becoming cluttered.

It could be argued that the 'new' section 103(1) does not postulate two quite separate and distinct 'purpose' tests.

The main and original purpose test concerned the purpose of the taxpayer in entering into a particular 'transaction, operation or scheme'. If the purpose of the taxpayer entering into the scheme was to avoid tax, then the purpose test was met.

The additional 'purpose test' relates only to the manner in which the transaction was entered into or carried out. The test contemplates two different purposes behind the choice of the manner in which a transaction is entered into or carried out.

- First, the purpose in choosing the manner employed might be dictated by *bona fide* business reasons or,
- Secondly, there may have been some other purpose, for example, tax avoidance, behind the choice of the manner of carrying out the transaction.

The distinction might not be considered crucial were it not for the fact that the two purposes may be confused, with the result that a conclusion is reached that a particular transaction is vulnerable because the manner in which it was carried out is one which would not normally be employed for business purposes.

What if the transaction itself cannot be attacked under the 'new' section 103(1) because the main purpose of the transaction itself was not to avoid tax? Can section 103(1) be applied because an abnormal non-business purpose determined the manner used to carry out the transaction?

This leads to a consideration of the precise meaning of the term: 'transaction, operation or scheme'. This might be construed as being as follows:

- A 'transaction' means a contract, for example, a sale or lease.
- An 'operation' might be considered to be just one of the terms or conditions or one of the elements of that transaction.
- A 'scheme' might be said to be a number of interlinked transactions.

But, whatever interpretation is placed on those words, can it be said that an 'operation' may also be 'the manner in which the transaction or scheme is entered into or carried out'? If the answer is in the negative, it becomes all the more important, in every case in which the question of section 103(1) is being examined to carry out the following:

- Identify, clearly, and isolate the 'transaction' or 'operation' or 'scheme', which is being subjected to attack.

- Consider the application of the principles enunciated in *Louw's*⁴⁹ case as well as those in *Hicklin's*⁵⁰ case since these cases are still applicable for transactions not in the context of business.
- Identify, clearly, the taxpayer who has avoided tax.
- Identify the tax that has been avoided.
- Ascertain the purpose of that taxpayer in entering into the identified transaction.
- Identify the manner in which a transaction of that nature would normally be entered into for *bona fide* business purposes and,
- compare it with the manner in which the transaction in question was actually entered into and carried out.

⁴⁹ 83 AD 551, 45 SATC 113.

⁵⁰ 80 AD 481, 41 SATC 179.

Conclusion

Does section 103 allow the Commissioner to reopen any taxpayer's past assessment irrespective of the time period that has elapsed since the date of the assessment?

Practice Note 20, dealing with section 103 of the Income Tax Act, was issued on 25 June 1993 in *Government Gazette* 14877.

It states that concern has been expressed that the Commissioner has the right to reopen an assessment and apply section 103 of the Act to it irrespective of the time period that has expired since the date of the assessment.

The view of the Commissioner is that the raising of additional assessments in terms of section 103 is subject to the restrictions imposed by the first proviso to section 79 of the Act. In other words, additional assessments may not be raised after the expiry of three years from the date of the assessment unless the Commissioner is satisfied that the amount which should have been assessed to tax was not so assessed due to fraud, misrepresentation or non-disclosure of material facts.

It is now necessary to explore the link between section 89*quat* and section 103(6).

Section 89*quat* deals specifically with the charging and earning of interest on underpayments and overpayments of provisional tax.

Section 103(6) obliges the Commissioner to charge interest on the underpayment of provisional tax in the event of the underpayment arising because of the taxpayer engaging in a tax avoidance scheme which has been successfully attacked by the Commissioner under section 103.

Section 103(6) reads as follows:

'Where the Commissioner has applied the provisions of this section in the determination of any taxpayer's liability for any tax, duty or levy imposed in terms of this Act, the Commissioner shall not exercise his discretion in terms of the provisions of section 89*quat* (3) or (3A) so as to direct that interest shall not be payable in respect of that portion of any tax which is attributable to the application of this section.'

Section 89*quat* (2) reads as follows:

'If the taxable income of any provisional taxpayer as finally determined for any year of assessment exceeds-

- (a) R20 000 in the case of a company; or
- (b) R50 000 in the case of any person other than a company,

and the normal tax payable by him in respect of such taxable income exceeds the credit amount in relation to such year, interest shall, subject to the provisions of subsection (3), be payable by the taxpayer at the prescribed rate on the amount by which such normal tax exceeds the credit amount, such interest being calculated from the effective date in relation to the said year until the date of assessment of such normal tax.'

Section 89*quat* (3) reads as follows:

'Where the Commissioner having regard to the circumstances of the case is satisfied that any amount has been included in the taxpayer's taxable income or that any deduction or allowance claimed by the taxpayer has not been allowed, and the taxpayer has on reasonable grounds contended that such amount should not have been so included or that such deduction or allowance should have been allowed, the Commissioner may, subject to the provisions of section 103 (6), direct that interest shall not be paid by the taxpayer on so much of the said normal tax as is attributable to the inclusion of such amount or the disallowance of such deduction or allowance.'

Section 89*quat* (3A) reads as follows:

'Where any natural person has, in respect of the year of assessment during which he for the first time became a provisional taxpayer, became liable for the payment of interest under subsection (2), the Commissioner may, subject to the provisions of section 103 (6), if he is satisfied that the circumstances warrant such action, direct that interest shall not be paid by such person in respect of such year of assessment.'

Section 89*quat*(3) and (3A) afford a discretion to the Commissioner. Because of the discretion afforded to him in terms of these subsections, he may or may not charge a taxpayer interest in the following circumstances:

- Where the taxpayer in good faith excluded an amount from his taxable income or included a deduction expecting the Commissioner to allow the exclusion or inclusion respectively, and the Commissioner subsequently disagrees with the taxpayer's treatment of the amount, and increases the taxpayer's taxable income.
- Where the taxpayer becomes a provisional taxpayer for the first time and presumably because of the changeover becomes liable for the payment of interest.

Section 103(6) takes this discretion away from the Commissioner where he has applied the provisions of section 103(1) in the determination of any taxpayer's income tax liability, that is, if a taxpayer unsuccessfully engages in a tax avoidance transaction, operation or scheme and falls foul of the provisions of section 103(1), he will pay interest at the prescribed rate on the amount of tax that should have been paid had he not embarked on the tax avoidance scheme.

The taxpayer will also have to pay the additional tax that he did not initially pay, as a result of him entering into the tax avoidance scheme.

There is now a disadvantage to taxpayers in the form of an interest liability should their tax avoidance schemes fall foul of the 'new' section 103(1).